

For discussion  
on 16 January 2018

**Legislative Council  
Panel on Commerce and Industry**

**Progress on the Establishment of  
the Innovation and Technology Venture Fund**

**PURPOSE**

This paper briefs the panel on the establishment of the Innovation and Technology Venture Fund (“ITVF”) and its progress.

**BACKGROUND**

2. The 2016 Policy Address announced that the Government would establish a \$2 billion ITVF to encourage investment from venture capital (“VC”) funds in local innovation and technology (“I&T”) start-ups. Funding for the ITVF was approved by the Finance Committee of the Legislative Council on 12 July 2016.

3. The Government will co-invest with VC funds in local I&T start-ups at an overall ratio of approximately 1:2. We expect that the ITVF could help local I&T start-ups meet funding needs and provide them with professional management knowledge as well as business and marketing network through the support and participation of venture capitalists.

**DETAILS OF THE PROPOSAL**

4. The implementation details of the ITVF are set out below -

***Special-purpose Vehicle for ITVF***

5. We have incorporated a limited company called The Innovation and Technology Venture Fund Corporation (“ITVFC”) in early 2017 as a special purpose vehicle to perform all investment activities. All investment returns would be deposited into the dedicated bank accounts of ITVFC for the purpose of further investment.

### *Advisory Committee*

6. We have appointed an independent Advisory Committee comprising veterans from the business and investment sectors as well as professionals and academics to advise on matters relating to the selection of co-investment partners (“CPs”) and operation of the ITVF.

### *Master Agreement between the Government and Partner VC Funds*

7. The Government and each selected partner VC fund will establish contractual relationship through signing a master agreement (“MA”) which sets out the details of cooperation as well as the rights and obligations of each party. The MA is drawn up based on the following key terms -

#### *Eligibility of VC Funds*

8. A VC fund, whether it is a newly established or an existing fund, and regardless of its place of incorporation, is eligible to apply if it meets the following criteria -

- (a) having an investment focus in I&T start-ups;
- (b) having an investment coverage including Hong Kong;
- (c) having a minimum remaining committed capital<sup>1</sup> of \$120 million (as at the date of application); and
- (d) having a remaining fund life of at least five years.

#### *Eligibility of Investee Companies*

9. The investee companies should meet the following criteria -

- (a) it should be an enterprise incorporated in Hong Kong under the Companies Ordinance within the last seven years with one of its offices (headquarters or regional office) or its main business operation or its key management or leadership team being located in Hong Kong;
- (b) it and its subsidiary(ies) (if any) have been engaging in I&T business, covering any part of the research and development or production chain in Hong Kong, since its incorporation; and
- (c) it and its subsidiary(ies) (if any) have a total number of employees less than 250 (including Hong Kong and overseas offices).

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<sup>1</sup> “Committed capital” means the capital commitment made by the investors to the VC fund.

*Limitation on the Size of Investment*

10. To avoid over-concentration of risks, ITVFC will set its investment limits for each CP and investee company -
- (a) the aggregate amount of ITVFC's investments with a CP shall be capped at \$400 million;
  - (b) the aggregate ITVFC's investments in the same investee company shall be capped at \$50 million; and
  - (c) for each investment in an investee company, ITVFC's investment amount shall constitute not more than (i) 40% of the original total target investment amount sought by the investee company, or (ii) \$30 million, whichever is the lower.

*Fees and Incentives for CPs*

11. ITVFC will not pay any management fees to CPs or share the expenses incurred by CPs in performing its obligations under the MA, while those expenses arisen from statutory requirements (e.g. stamp duties, capital duties and relevant registration fees) will be shared by both parties. All other costs and expenses incurred by CPs in performing the MA (e.g. due diligence expenses and all legal costs incurred for the investments) would have to be fully borne by CPs.

12. Nevertheless, the following incentives will be available for CPs -
- (a) Upon the completion of sale of all ITVFC's shares in an investee company, ITVFC will, according to the payment arrangement described in the MA, pay a performance incentive equal to 35% of the realised gain arising from the sale. The realised gain is the net amount of the cash proceeds after deducting all investment cost, fees, expenses, taxes and stamp duty paid or payable by ITVFC for such investment; and
  - (b) A CP is provided with an option to purchase the shares in all of the investee companies in which ITVFC has been invited by the CP to invest within five years from the commencement date of the MA. The option is exercisable at a cost of the principal amounts plus relevant interests. The interest rates are defined by the rates of fee payables by the Exchange Fund to Government funds and statutory bodies for placements which are published by the Hong Kong Monetary Authority in respect of the relevant years. As reference, the said rates for the last few years were 3.6% (2014), 5.5% (2015), 3.3% (2016) and 2.8% (2017) respectively.

### *Exit of Investments*

13. During the validity of the MA, the CP should locate third party(ies) to acquire ITVFC's and the CP's stakes in the related investee companies. However, if ITVFC still holds shares of an investee company after the expiry of the MA, ITVFC has the right to request the investee company to redeem ITVFC's stakes.

14. If an MA is terminated early by ITVFC due to certain events of gross default by a CP (e.g. fraud, wilful misconduct, gross negligence, violation of criminal law, or breach of the MA), the CP is required to make an offer to ITVFC to acquire all the latter's stakes in all investee companies under the ITVFC's co-investment portfolio with that CP.

### **LAUNCH OF THE ITVF SCHEME**

15. The ITVF was launched on 15 September 2017 for VC funds to apply for becoming CPs. The application deadline is 15 January 2018. As at 5 January 2018, four applications have been received and, to our knowledge, a few other VCs will submit application. We expect to announce the selection result in the second quarter of 2018 and, following signing of MA with selected VC funds, begin receiving CPs' invitations for co-investment in local I&T start-ups in the second half of the year. We initially expect to partner with a few VC funds and co-invest with them in around 40 to 50 technology start-ups during the active investment period. However, the actual number of CPs and pace of investment would be affected by market conditions and investment sentiments, which are volatile and unpredictable.

### **TAX ISSUE**

16. Some offshore VC funds have expressed concerns over a potential tax issue in relation to the ITVF. Pursuant to Section 20AC(3) of the Inland Revenue Ordinance ("IRO") (Cap. 112), an offshore fund may lose its profits tax exemption status should it carry on any trade, profession or business in Hong Kong involving any transaction other than the "Specified Transactions" as defined in Part 1 of Schedule 16 to the IRO. Transactions in shares of private companies incorporated in Hong Kong are currently not "Specified Transactions". Hence, as far as some offshore funds are concerned, co-investing with ITVFC in local I&T start-ups may not be commercially justifiable.

17. We are now working with the Financial Services and Treasury Bureau, Inland Revenue Department and Department of Justice to address this issue through putting forward an legislation amendment to add a new category of “Specified Transaction” in Schedule 16 to the IRO to cover the transactions in relation to the ITVF.

18. Section 20AC(5) of the IRO provides that the Commissioner of Inland Revenue may amend Schedule 16 by notice published in the Gazette. The notice is expected to be published in the Gazette in April 2018.

### **ADVICE SOUGHT**

19. Members are invited to note the progress of the ITVF.

Innovation and Technology Bureau  
Innovation and Technology Commission  
January 2018